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CORPORATE FINANCE

VOLUME II

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CORPORATE FINANCE

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1. Introduction

All Canadian financial intermediaries, including banks, trust and loan companies, credit unions, caisses populaires, insurance companies, pension plans and investment companies (such as mutual funds) are subject to portfolio regulation which has the purpose of reducing the riskiness of investment in an intermediary by affecting the structure of its portfolio of assets and liabilities. A central means of regulating the riskiness of financial intermediaries in Canada is statutorily prescribed asset constraints. These constraints require financial intermediaries to restrict investment of their funds to those investments authorized by legislation. Authorized investments are known as the "legal list" or "legal for life" investments. An example of a legal list, which has been taken from the Canadian and British Insurance Companies Act, R.S.C. 1970, c. I-15, as amended, follows this note.

This note will discuss the historical roots of the legal list, its ostensible objectives and its underlying rationale in an attempt to demonstrate that it fails to implement the lessons of modern financial theory, fails to obtain its objectives and impedes national economic growth.

2. History

Before examining the efficacy of current "legal list" restrictions, the historical underpinnings of "legal list" legislation must be understood. History not only explains why legislation exists, it may also justify its continued existence.

"Legal list" restrictions exist in Canada because of the strong influence of English trust law and investment thinking on the development of Canadian law. English trust investment legislation was enacted first in 1859 by the Law of Property (Amendment) Act, 1859 (22 + 23 Vict., ch. 35). That legislation established a list of permitted investments authorizing investment in first mortgages and in securities guaranteed by the British government. Government securities and first mortgages were, at that time, the traditional investments of trusts, having received the imprimatur of the Court of Chancery as authorized investments in previous decisions.

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* In the preparation of this note, the author acknowledges the assistance provided by a 1984 Harvard LL.M. paper written by Clay Horner entitled "Regulation of Pension Plan Investment Decision Making in Canada: A Plea for Change."

Past events had caused investment in commercial enterprise to be regarded as unduly speculative for a trustee. First, the crash of the South Sea Company in 1720 greatly tarnished the reputation of commercial enterprise. The South Sea Company had been formed by the British government in 1711 and granted a monopoly over all trade to the South Seas. British investors, including trustees, became enamoured with the prospects of this trade and invested heavily in the shares of the South Sea Company. The stock price skyrocketed and the whole British nation became gripped by speculative fever. Promoters rushed new financing proposals to market, exploiting the greed and lust for immediate wealth of British investors. Market activity was marked by fraud, deceit, manipulation and rumor, apparently ubiquitous characteristics of any securities market. Proposals became increasingly extravagant and deceptive. Proposals included making salt water fresh, making boards from sawdust and importing jackasses from Spain (though there appeared to be no lack of them in Britain, at least in the securities markets). One proposal was even for "A Company for carrying on an undertaking of great advantage, but nobody to know what it is."

The bubble soon burst. The directors and officers realized that the price of the shares bore no relationship to the company's real prospects and sold out. The news leaked and the stock plummeted. Shareholder hopes changed to shareholder despair precipitating a panic which caused the stock market to crash. For an interesting account of the South Sea Bubble and other instances of speculative fever leading to price collapses, see Chapter Two, "The Madness of Crowds", in Burton G. Malkiel, A Random Walk Down Wall Street (New York: M.W. Norton & Company, Inc., 1973).

The next matter causing investment in commercial enterprise to be regarded as unduly speclative for trustees was the economic strain of the Napoleonic Wars of early nineteenth century Britain which caused several bankruptcies of commercial enterprise.

The traditional and deep-rooted view that commercial and industrial stocks were too speculative for investment by trustees persisted for decades and was buttressed by the experience of the Great Depression. It did not change until the economic aftermath of the Second World War. The British trust system was built upon the stability of the pound sterling and the reliability of the good standing of the government securities in which so much of trusts' assets were held. The British economy was devastated by the Second World War and the immediate post-war years were characterized by a weak pound sterling, high interest rates, high unemployment, a wage-cost spiral of increasing prices, and a slide in the prices of government securities. In contrast, industrial and commercial equities prospered during the 1950s as an effective hedge against inflation.

The law was slow to react to the growing popularity of industrial and commercial securities, but settlors of trusts quickly eschewed the restrictive parameters of the "legal list" and increasingly granted trustees the discretionary power to invest in those securities. Finally, in 1961, the "legal list" was amended by Parliament to permit investment of up to 50 percent of a

trust's assets in commercial and industrial securities. However, the new legal list continued to take a conservative approach by allowing an investment in a commercial or industrial enterprise only if it had met prescribed earnings, dividend or interest payment criteria.

The British legacy has been evident throughout Canadian history. The economic circumstances of the Canadian provinces were distinct enough to justify a departure from the British approach to trustee investments because those provinces had neither the commerce nor capital of Britain. However, the legislation enacted by Canadian jurisdictions essentially paralleled and followed British legislation. As in Britain, settlors increasingly gave trustees complete discretion, and gradually the "legal list" became irrelevant. Within the last thirty years, the "legal list" has been expanded to include corporate bonds, debentures and shares meeting prescribed earnings, dividend or interest payment standards and subject to a maximum limit on the proportion of such investments.

The development of British and Canadian trust investment powers has been traced because of its illustrative value for the the investment powers of Canadian financial intermediaries. The evolution of the investment powers of financial intermediaries has tended to parallel that of trustees. The history which explains the conservatism of trustee investment powers also explains the current asset restrictions governing financial intermediaries. The South Sea Bubble, the Napoleonic Wars, the Great Depression and the aftermath of the Second World War explain the current form of investment power legislation, but they do not necessarily justify it. Analysis later in this note questions the appropriateness of the current form of this legislation when examined in the context of modern financial theory.

3. The Four Stages of Financial Capitalism

Any analysis of the regulation of financial intermediaries is best performed within a theoretical construct. Professor Robert Clark of Harvard University has advanced in a recent article, "The Four Stages of Capitalism: Reflections on Investment Management Treatises" [94 HARV. L. REV. 561(1981)], a particularly insightful construct. Professor Clark posits that there have been four distinct stages of financial capitalism in the United States and that each stage has been characterized by distinctive problems to which the legal system has tried to respond by adding a fundamentally new kind of regulation. The first stage, the age of the entrepreneur, saw the development and institutionalization of commercial enterprise. It was characterized by the enactment of general incorporation statutes and other "enabling laws".

The second stage, the age of the professional manager, witnessed the separation of ownership and management through the development of the modern publicly held corporation. During this second stage, modern securities laws were enacted.

The third stage of financial capitalism is the age of the portfolio manager. Its characteristic institutions are the institutional investor and the financial intermediary. Increasingly, the decision about how to invest capital became separate from the decision to supply capital for investment. Investors decided to save and then turned to portfolio managers or financial intermediaries to decide how to invest those savings. This third stage of financial capitalism saw a significant increase in the role of financial intermediaries in the capital markets. The basic regulatory approach of the third stage has been termed "soundness" by Professor Clark. A variety of methods have been employed to insulate suppliers of capital from the consequences of failure by regulating the riskiness of financial institutions. Strategies of risk regulation include anticompetitive regulation, portfolio regulation, insider misconduct regulation and industry compensation, guarantee or deposit insurance schemes. Portfolio regulation is the primary concern of this note.

The fourth stage has been labelled the age of the savings planner. It is characterized by the splitting of the decision to supply capital into the possession of beneficial claims and the decision to save. The decision about whether and how much to save is becoming more and more a group decision. For example, corporate affairs and union representatives who bargain over employee pension plans are the new professional savings planners. The expansion of the fourth stage has led to a corresponding increase in the significance of the third stage as savings planners rely on outside investment counsel. The fourth stage has been characterized by legislation governing the activities and duties of savings planners and defining the rights of participants in and beneficiaries of employee and other benefit plans.

4. The Reasons for "Soundness" Regulation

The legislative response to the third stage of financial capitalism has been a concern for the soundness of financial intermediaries. One form of soundness legislation has been portfolio regulation. As mentioned earlier, this type of regulation has manifested itself in Canada most prominently though the "legal for life" asset investment restrictions. No examination of these restrictions is complete unless the underpinning rationale for special soundness regulation for financial institutions is analyzed. The regulation of financial institutions differs from that of commercial and industrial corporations where most regulation is directed at ensuring that there is full disclosure of relevant information.

Several justifications exist including consumer protection, ensured stability of the financial system, the precariousness of the highly levered nature of financial institutions' balance sheets and protection against self-dealing.

5. The Merits of the Legal List

The "legal list" purports to guarantee that an investment meeting its criteria is a sound one. However, it fails to ensure soundness in several respects. For instance, the "legal list" is based on historical information while the investor's primary concern about the

investment should be prospective. The investor should be concerned about such matters as the health, integrity, competence and experience of management and extrinsic factors like future developments in technology, the competitive environment of the business, and political and economic trends. A sophisticated assessment of an investment's prospects goes well beyond the historical criteria required by the "legal list".

Furthermore, the criteria of the "legal list" tests may not provide meaningful information. For example, consider the dividend test which qualifies investment in preferred and common shares (see, s.63(1)(l) and s.63(1)(m) of the Canadian and British Insurance Companies Act, infra). The regular payment of dividends is not a guarantee of long-term soundness. Dividends do not have to be paid out of profits. Modern corporation statutes permit the payment of dividends by a corporation if there are reasonable grounds for believing that the corporation will continue to be able to pay its liabilities as they fall due and the realizable value of the corporation's assets after payment of the dividend exceeds the aggregate of its liabilities and the stated capital of all classes of its shares (see s.40 C.B.C.A. and s.38(3) O.B.C.A.). Thus, dividends may be paid out of the real value of any retained earnings and capital surplus held in the corporation. In turn, a dividend paid out of capital surplus might be paid from surplus artificially generated by a reduction in stated capital since modern Canadian corporation statutes allow the reduction of stated capital by a special resolution of shareholders for "any" purpose (see s.36(1) C.B.C.A. and s.34(1)(b) O.B.C.A.). Not only does the dividend record test permit investment in less than sound companies, it may preclude investments in new companies with a promising future and in companies without a long-term dividend record where recent changes have created favourable prospects.

The inflexibility of the "legal list" has been noted earlier. Financial markets change rapidly. New instruments are frequently being introduced. Yet the legal list is static. It may not be possible to construe some new instruments as eligible for investment pursuant to any of the categories of the legal list, except the "basket clause" (see, for example, section 63(4)(c)(iii) of the Canadian and British Insurance Companies Act, infra). For example, hedging strategies available to financial intermediaries through the use of options and futures are hindered because these instruments are not encompassed specifically by any legal list investment category. Changes to the legal list require legislative or regulatory action, which is usually a slow, plodding procedure.

A further shortcoming of the legal test is that a company whose investments qualify as eligible for investment is regarded often by segments of the public as sound. The forementioned weaknesses of the historical criteria of the "legal list" undermine the validity of any such assumption, particularly when exploited by the machinations of lawyers. For example, certain prescient law firms have assembled an inventory of shelf "legal for life" companies. A company incorporated five years ago with a capital of $100 which was invested in high quality preferred shares yielding an annual dividend of greater than 4 percent would have sufficient earnings to have its common and preferred shares qualify as

legal list investments. The shelf company could then be merged with a new company, making the new company's common and preferred shares immediately eligible under the "legal list" criteria. In fact, a secondary market has developed for these shelf "legal for life" companies, with some fetching prices of $20,000 and more.

The trust law antecedents of the "legal list" have caused its focus to be the preservation of capital. The reality, however, is that investments have a second objective as well, the generation of income. By making the risk of capital loss its central focus, the "legal list" does not encompass or reflect fully the lessons of modern financial theory.

Modern financial theory views risk as a measure of the variability of expected investment returns. This conception of risk takes into account the entire range of future values of the investor's portfolio, rather than only those future values which are less than cost (as is encouraged by the preoccupation of the "legal list" with preservation of capital).

Modern financial theory also recognizes that a security has two dimensions: its expected return and its risk. The focus of the "legal list" on risk of loss fails to recognize that every investor faces a trade-off: he will accept the marginal risk a security adds to an investment portfolio if that risk is offset by an adequate increase in expected return.

Modern financial theory highlights the importance of diversification as a means of reducing risk. Diversification may reduce risk in two ways: by eliminating "unsystematic" risk or by reducing covariance among the individual investments comprising the investment portfolio. By arbitrarily restricting the range of permitted investments, the "legal list" inhibits a realization of the full benefits of asset diversification.

6. Conclusion

The current Canadian "legal list" approach to portfolio regulation appears costly and misdirected. Its primary objective is to ensure that an investment is sound, but it fails to provide any such guarantee. It impedes the diversification of investment prescribed by modern financial theory and it may hinder the development of the risk/return trade-off desired by the management of a financial intermediary.

Furthermore, the legal list may constitute a significant roadblock for national economic development. The Royal Commission on Corporate Concentration found, in 1978, that Canada had a developing shortage of investment capital. An important aspect of that shortage is the weakness of the market for new equity issues. The conservatism of Canadian financial institutions is a major factor in the shortage of the supply of equity capital. Not only does a much higher proportion of funds flow through the institutional investment process in Canada than in the United States, major Canadian financial institutions traditionally have invested a much lower proportion of their total assets in equities than have their U.S. counterparts.

Financial institutions have tended to favour the equities of large, well-capitalized companies, preventing small and medium-sized companies from obtaining the capital they need in a market dominated by institutions. The Royal Commission on Corporate Concentration noted a marked lack of money for start-up situations in Canada. The legal list approach to asset constraints creates an obstacle to increased institutional investment in small and medium-sized businesses because such investments usually fall under the basket clause which is limited to a small percentage of total assets (generally around seven percent).

c) **NOTES AND QUESTIONS**

(1) As indicated above in the discussion of appraisal rights, there are many different contexts in which a company can "go private". These include two-step freezeouts, parent-subsidiary freezeouts (involving either public or private parent companies), and "pure" going private transactions. In this section, we focus mainly on the latter.

A pure going private transaction is one engineered by the current controllers of the corporation, whether these are the managers, majority shareholders, or both. A difference from two-step freezeouts beginning with an arm's-length takeover bid is that the acquirors in a pure going private transaction start out from a non-arm's length position. Pure going private transactions also differ from parent-subsidiary combinations in which the minority shareholders of the subsidiary are frozen out: in the latter, it is generally conceded that the union of the two corporate enterprises may create substantial efficiency gains (e.g. from eliminating duplicated operations, unifying administrative hierarchies, etc.).

Pure going private transactions have been strongly attacked by a number of leading legal academics, who suggest that the only serious aim of going private transactions is to enrich insiders (see e.g. Brudney and Chirelstein, supra). This has resulted in the suggestion that pure going private transactions be prohibited. The source of the concern stems from the fact that those who engineer the transaction - and set the price - are in possession of inside information which may tell them that the enterprise is worth far more than the current market value (recall, markets are not "strong form" efficient, and therefore the insider information will not be reflected in share prices). In such cases, the insiders will go private in order to capture for themselves those values latent in the enterprise but shielded from the purview of public shareholders. These same critics argue that the prospective benefits of pure going private transactions, on the other hand, are small or non-existent. There are no transaction "synergies" which arise from the merging of compatible operations. Nor are there benefits from a change in control, since there is none. See (in addition to the articles excerpted at the start of this chapter) Brudney, "A Note on Going Private", 61 Va. L. Rev. 1019 (1975) (strongly favouring a prohibition). See also Greene, "Corporate Freeze-out Mergers: A Proposed Analysis", 28 Stan. L. Rev. 487 (1976) (also favouring a prohibition). But cf. Borden, "Going Private - Old Tort, New Tort, or no Tort?" 49 N.Y.U.L. Rev. 987 (1974) (citing possible efficiency benefits but favouring a majority of the minority test for approval).

The evidence marshalled by DeAngelo, DeAngelo and Rise, in "Going Private: The Effects of a Change in Corporate Ownership Structure" (above) suggests that there are in fact potentially significant gains which may result from pure going private transactions, and that public shareholders participate in these gains by reason of receiving a premium over the previously prevailing market price.

Do the empirical results in this piece go all the way in arresting fears that management is exploiting inside information in its decision to go private? Suppose, for example, that the shares of a company are trading at $10. Suppose as well that if all information in possession of the corporate insiders were revealed to the market, that the price would jump to $30 per share. Are public shareholders better or worse off if management cashes them out at $20 per share? Has management, in fact, violated its fiduciary duty to the public shareholders, in concealing or failing to release to the market the information which might be

expected to result in a re-evaluation of the company's stock? Are there dangers, if we permit pure going private transactions, that management might be tempted to withhold information from the market precisely in order to achieve such a result?

DeAngelo et al. suggest that the results of their investigations are strong evidence that pure going private transactions do in fact generate real economic gains. Consider whether the results could also be explained by assuming, not that real economic gains resulted, but that the value of the companies tested, when measured against the standard of inside information, may have been sufficiently great to allow cashout at a premium, and yet still enrich the insiders at the expense of public shareholders (assuming that hidden values really belong to the public shareholders)?

(2) Read carefully s.189 of the OBCA and the OSC's Policy statement 9.1. Does the disclosure requirement adequately meet the concern of insider exploitation of information (if, indeed, there is a problem)? How "independent" is a valuation performed by a firm hired by management likely to be? Is the situation likely to be any different in respect of a broker/investment dealer or other expert valuer who may expect (or hope) to receive future business from the corporation or from other corporations (in this respect, recall the comments of the British Columbia Court of Appeal in Re Bellman and Western Approaches, in BECK, 671)? In any case, is the valuation likely to reflect inside information (how much inside information is subject to documentary discovery)? If the valuation is inaccurate, how is a shareholder to discover this ex post, given that when the corporation goes private he or she will cease to have any means of monitoring the corporation's performance?

(3) Does the majority of the minority approval requirement make up for this deficiency (if there is one)? Or does it also suffer from the problem that shareholders may not be in possession of the relevant facts (after all, a true approval must be an informed approval)?

(4) On the other hand, is it possible to argue that these protections are unnecessary, or even burdensome? What are some of the potential costs of the protections embodied in OBCA s.189 and Policy 9.1? In an efficient market, is there any need to mandate these protections? Why wouldn't we see them voluntarily coming into existence in corporate charters? Are there drafting problems which would impede moves towards adoption of such requirements in the constitutional documents of the company?

(5) Going private transactions can be engineered in a great number of forms. These include the following:

(i) a freezeout amalgamation, as in Carton (supra) and Westeel-Rosco (BECK, 717) or Neonex v. Kolasa (see "Appraisal Rights", supra) (this can be used to accomplish a pure going private transaction by means of the majority shareholders forming a company specifically for the purpose of amalgamating it with the target company);

(ii) a reverse stock split (or "consolidation freezeout") whereby the shares of the company are, by constitutional amendment, consolidated into a small number of shares (e.g. 5000 old common shares become 1 new common share), with fractional shares purchased by the company (eliminating most or all public shareholders);

(iii) sale of assets to the majority shareholders or a company controlled by them and a subsequent dissolution of the company (see e.g. the famous case of Menier v. Hoopers' Telegraph Works (1874), L.R. 9 Ch. App.350 (BECK, p.369).

(iv) amendment of the articles of incorporation to convert public shareholdings into redeemable preferred shares which are then redeemed by the corporation (see Standard Manufacturing, below: see also In The Matter of Cablecasting, supra).

These techniques may be employed through (inter alia) statutory amalgamation, sale of assets, or liquidation and dissolution provisions, or effected as an arrangement with court approval.

In addition, a majority anxious to rid themselves of a minority may adopt tactics, like deliberate withholding of dividends or taking actions resulting in de-listing of the company's stock from the stock exchange, which are calculated to drive minority shareholders out of the company (by precipitating a sale of the minority interest to the majority).

The following cases illustrate two of the above methods (each effected by arrangement). Each of these cases represents a potentially important contribution to the universe of minority shareholder protections not merely on going private transactions effected by arrangement (indeed, in Ontario, the holding in Standard is rendered redundant by s.189 and Policy 9.1) but in respect of other transactions as well.

(i) RE RIPLEY INTERNATIONAL LTD.
(1977) 1 B.L.R. 269 (O.H.C.J.)

16th June 1977. SOUTHEY J.:—This is an application by Ripley International Limited under s. 194 of The Business Corporations Act [R.S.O. 1970, c. 53] for an order approving a scheme of an arrangement for the reorganization of the authorized capital of the applicant. The scheme was approved by the directors of the applicant and was adopted by a vote of 99.5 per cent of the votes cast at a meeting of shareholders held on 28th April 1977.

The applicant is a public corporation, but the number of shares held by persons other than directors and senior officers has been reduced greatly in recent years, under circumstances which I shall describe later, to the point where 522,170 of the 535,395 shares presently issued and outstanding (of 97.5 per cent) are now owned by directors or senior officers. The purpose of the proposed arrangement is to enable the applicant to qualify as a private corporation, thereby achieving substantial tax savings. The effect of the arrangement would be to remove as shareholders all, or virtually all, persons who are not now directors or senior officers, by consolidating the presently issued shares on a one for 5,000 basis. Any fractional shares resulting

3. The Legality of Shark Repellants

i) Note

The legality of any or all types of shark repellent in Canada is not entirely clear. From Bus. Org I. you should recall that the English (and until recently, the Canadian) cases held that an issuance of shares with the primary purpose of defeating a takeover bid was per se improper and a breach of the fiduciary duties of directors. In the English cases the issuance has always been said to be voidable, and hence capable of being ratified by shareholders. On the other hand, in the Canadian case of Bonisteel and Collis, in the Bus. Org. I materials, the issuance was said to be void. The situation has changed dramatically in Canada with the judgements of Berger J. in Teck v. Millar in the B.C. Supreme Court, Olson v. Phoenix Industrial Supply in the Manitoba Court of Appeal, and the Supreme Court of Ontario in Olympia and York v. Hiram Walker (all in the Bus. Org. I materials)(see also Exco Corp. Ltd. and Nova Scotia Savings and Loan Co., unreported, Feb. 4, 1987, Mr. Justice K. Peter Richard in the Supreme Court of Nova Scotia, Trial Division, apparently adopting a version of the Teck test). These cases hold, in effect, that the "proper purpose" test is no longer distinct from the question of whether or not the directors acted honestly, in good faith, and with a view to the best interests of the corporation, although it would appear that there is a superadded requirement that the directors be acting on reasonable grounds. Thus, at least in Canada, where directors have an honest belief on reasonable grounds that defeating a takeover bid is in the best interests of the company, they may well be able to make an issuance of shares to effect this purpose.

Whether or not other takeover defences fall in the same camp has not been litigated. However, the Ontario Securities Commission penalized the two senior officers of Royal Trustco for certain actions taken in connection with the defeat of a hostile takeover bid undertaken by Robert Campeau, by issuing a denial of exemptions under s.124 of the Securities Act (see [1983] 5 OSCB 1593). The officers had failed to disclose to the public during the currency of the bid that they were seeking a white knight to defeat the bid; they also failed to disclose (once it had become apparent) that they had marshalled sufficient shareholder support (mostly on the part of institutional investors) to defeat the bid.

Further, OSC Policy 9.4 (in the Bus. Org. I supp. at 201: Cf. National Policy 38, which is substantially the same in substance) indicates that the Commission may intervene "where it becomes aware of defensive tactics that will likely result in shareholders being deprived of the ability to respond to a take-over bid or to a competing bid." The Policy also indicates that "[t]he Commission appreciates that defensive tactics, including those that may consist of some of the actions listed in paragraph 4 [including an issuance of securities, sale of an asset, or entering into non-ordinary course contracts] may be taken by a board of directors in genuine search of a better offer." Thus, although the Commission is prepared to intervene in an appropriate case, it has indicated that defensive tactics may be benign in certain situations.

The following ruling by the Ontario Securities Commission indicates one avenue through which the Commission and the Toronto Stock Exchange may get involved in a case involving an issuance of shares to defeat a takeover bid. This case will give you an indication of the sanctions available to the Toronto Stock Exchange (and the limitations of these sanctions) and also one of the most important discretionary remedies of the Ontario Securities Commission -- the power to deny trading exemptions under s.124 of the Securities Act (the other being the cease trade power in s.123 of the Act).